STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Petition for approval of delivery services tariffs and tariff revisions and of residential delivery services implementation plan, and for approval of certain other amendments and additions to its rates, terms, and conditions.	: : : : : :	No. 01-0423

Rebuttal Testimony of

PROF. SAM PELTZMAN

Ralph and Dorothy Keller Distinguished Service Professor of Economics
in the
Graduate School of Business, The University of Chicago

ComEd Ex. 29.0

Q. Please state your name and business address.

A. Sam Peltzman, Graduate School of Business, The University of Chicago, 1101 East 58th Street, Chicago, Illinois 60637.

Q. Are you the same Prof. Peltzman who previously filed testimony in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. In my direct testimony, I explained why the restructuring of the electric utility industry is likely to add new risks to ComEd's distribution business as a result of both general and specific forces that I described. Several witnesses including City of Chicago witness Steven Walter, ARES Coalition witnesses Dr. Phillip O'Connor and Mr. Richard Spilky and Illinois Commerce Commission Staff witness Ms. Janis Freetly have commented on my testimony. In this rebuttal, I will respond to their comments.

Q. Mr. Walter acknowledges your study in 1976 of the buffering effect of regulation, and the related conclusion that less regulation leads to increased risk. (City of Chicago Ex. 1.0, pp. 5-60). However, he argues that academic studies that have analyzed the "'Peltzman effect' are not monolithic" and "there is not unanimous opinion as to the validity of the Peltzman effect." (City of Chicago Ex. 1.0, pp. 6-7). Is your opinion that restructuring is likely to increase the risk of ComEd's distribution business affected by the absence of unanimity among scholars who have discussed your study?

A. No. Debate about the conclusions of such studies is normal. There is rarely unanimity on any subject of this complexity. The point I made in my direct testimony is that there have been studies since my work in 1976 that have attempted to test my conclusion, and, broadly speaking, it does appear that less regulation of electricity increases risk. There is nothing in the studies that have been conducted since 1976 that persuades me to the contrary and much that confirms the validity of my conclusion.

Q. Mr. Walter suggests that the work of Prof. Nwaeze indicates that small utilities are more vulnerable to adverse consequences from restructuring than large ones. (City of Chicago Ex. 1.0, p. 7). Does that support the conclusion that restructuring will not increase the risk of ComEd's distribution business?

A. No. Whether a utility is large or small, it is likely that removing the buffering effects of regulation will increase risk. There is no persuasive evidence that the increased risk arising from restructuring affects small utilities alone.

Q. Mr. Walter also states that "academic studies are of little use to us here" in determining "market expectations of earnings corresponding to particular levels of risk." (City of Chicago, Ex. 1.0, pp. 7-8). Is Mr. Walter's testimony correct?

A. No. In establishing ComEd's delivery services rates, it is necessary to determine the investor-required return on equity capital used in the business. The return that investors require depends on the risks of the business. A careful analysis of the forces that affect business risks is clearly an important step in the process. The suggestion that a study of those forces and of the risks that they create is of little use is simply wrong.

Q. Is Mr. Walter correct (City of Chicago Ex. 1.0, pp. 8-9) that your study deals only with theory, and not with the risks that will matter to investors in practice?

A. A. No. My work, and the work of those who have followed it, is not about theoretical risks that have nothing to do with the reality of businesses undergoing deregulation and restructuring. We are not analyzing the risk perceptions of academics, as Mr. Walter suggests. We are studying the real-life risks that are experienced by this industry and that get reflected in the prices of its securities.

Q. Dr. O'Connor and Mr. Spilky comment that your testimony does not analyze particular ComEd tariffs, such as Rider PPO (Market Index) or Rider ISS – Interim Supply Service. (O'Connor/Spilky Direct Testimony pp. 54-55). Do their comments affect your conclusion that the restructuring of the electric industry and ComEd's obligations as a provider of last resort create new risks for ComEd's distribution business?

A. A. No. The purpose of my testimony was not to analyze particular ComEd tariffs. I understand that other witnesses have addressed those topics. I commented in my testimony that it was my understanding that ComEd does not have the authority to pass through to retail customers all of the costs and losses that may arise from its obligations as the provider of last resort. Because it does not, investors will be concerned about the risks posed by ComEd's provider of last resort obligations. The testimony of Dr. O'Connor and Mr. Spilky does not indicate that ComEd's tariffs guarantee that it will recover all of the costs arising from these obligations and I understand that the rebuttal testimony of Arlene Juracek to be submitted by ComEd will confirm that there is no such guarantee.

Q. Dr. O'Connor and Mr. Spilky suggest that, when the freeze on ComEd's bundled rates is removed, it will have an opportunity to seek a rate increase that cannot exceed a market value amount determined under the law plus 10%. (O'Connor/Spilky Direct Testimony p. 53). Does that affect your view that investors will take into account ComEd's provider of last resort risks in the new restructured electric industry?

A. No. As I explained in my direct testimony when discussing a related question – whether ComEd could obtain full cost pass-through authority in the future:

> After 2005, ComEd may – or may not- obtain full pass through provisions from the regulators. However, the capital market cannot assess with certainty what a 2005 regulator might do. So ComEd's equity bears the uncertainty about this issue today. (ComEd Ex. 9.0, pp. 10-11)

> I would make the same observation about the possibility that future rate increases may be granted. Unless investors can be sure that the costs of meeting ComEd's obligations as provider of last resort will be recovered, they will be concerned about the risk that they will not, and that risk will affect the cost of equity capital.

Q. Dr. O'Connor, Mr. Spilky and Mr. Walter contend that ComEd voluntarily divested its generation assets. (O'Connor/Spilky Direct Testimony, p. 51; City of Chicago, Ex. 1.0, p. 10). They therefore conclude that the cost of equity for the company's distribution business should not take into account the fact that the company has obligations as the provider of last resort, but lacks generation assets. Please comment on this testimony.

A. Their conclusion is incorrect. The distribution business' cost of capital has nothing to do with how it came to be separated from generation or even whether ComEd did or did not divest itself of generation assets, voluntarily or otherwise. The restructuring, by allowing entry into generation, makes generation an economically distinct business from distribution. Each business must now earn enough to cover all of its costs, including capital costs, if it is to retain capital in the long run. The distribution business' cost of capital is one that reflects all of the risks associated with that one business, including those imposed by the provider of last resort obligations.

Q. Mr. Walter contends that your analysis implies that ComEd was imprudent to transfer its generation assets. (City of Chicago Ex. 1.0, p. 11). Is that correct?

A. No. That is incorrect. First, as stated above, the economic reality of restructured distribution would be the same even if ComEd had never divested generation assets. Those assets would have to earn their way in a competitive marketplace regardless of who owned them. Second, the prudence of separating generation from distribution does not depend only on the risks this imposes on distribution. If it did, then the rationale for restructuring would be questionable. Presumably, allowing entry into generation and thereby ending the vertically integrated monopoly structure of the industry leads to a more efficient generation industry. The correct implication of my analysis is that these benefits also entail costs, one of which is the new risks created for the distribution business, and that these costs have to be compensated in order for the distribution business to retain capital.

Q. Ms. Freetly disagrees with your testimony about the risks facing ComEd's distribution business in the restructured electric industry, commenting that the restructuring of the industry has eliminated the risks associated with owning and operating generation. (Staff Ex. 5.0, p. 43). Is that a valid basis for disagreeing with the conclusions stated in your testimony?

A. No. My direct testimony takes into account that ComEd's distribution business is not subject to the risks of owning and operating generation assets. The point is that there are new risks that face the distribution business after restructuring. As I explained:

> Some risks previously borne by integrated utilities have been removed by restructuring. These are the risks associated with owning and operating generation. However, as I have argued above, there are new risks unique to restructured wires companies like ComEd that do not exist for integrated utilities. As the recent experience indicates, the risks to distributors created by vertical divestiture can be much greater than the risk they shed. (ComEd Ex. 9.0, p. 12).

Q. Ms. Freetly also refers to recent changes in ComEd's debt ratings. (Staff Ex. 5.0, pp. 43-44). Is she correct that these changes contradict the conclusions expressed in your testimony?

A. No. Changes in debt ratings for the company do not contradict my conclusions about the increased risks that will affect the cost of equity capital equity. Debt investments and equity investments have different risks. Debt rating agencies are most concerned with the risks facing debt holders – primarily the risk of default. Equity investors are concerned about the risks of an equity investment. As I explained in my direct testimony:

> restructuring will increase the impact of demand fluctuations on the variability of ComEd's cash flow. Given these risks, the capital markets will demand a risk premium on ComEd's cost of equity capital. (ComEd Ex. 9.0, p. 8).

Investors will be concerned about the volatility of an .equity investment in ComEd's distribution business arising from the new risks posed by restructuring and the company's obligations as the provider of last resort. As the direct testimony of Dr. Culp explains, these risks cannot be eliminated by diversification and therefore they will affect the cost of equity capital.

Q. Does this conclude your testimony?

A. Yes.